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COSTA RICA
POLICY TOOLS FOR RURAL FINANCE

FINANCIAL DEVELOPMENT IN COSTA RICA
A LONG-TERM VIEW

by

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1. The Importance of Financial Deepening

The role of the financial system and the nature of its contributions to economic growth have received increasing attention. These contributions are associated with the provision of at least four types of service. The most basic is the provision of a medium of exchange (monetization of the economy), which reduces the costs of conducting transactions in commodity and factor markets, increases the flow of trade, and enlarges market size. This improves the productivity of resources, through specialization and the division of labor, greater competition, the use of modern technologies, and the exploitation of economies of scale. Since the efficiency of this service is reduced by inflation and currency substitution (dollarization), correct macroeconomic management is crucial for adequate monetization.

The financial system also provides services of intermediation between savers and investors, thus enhancing the accumulation of capital and improving its allocation. In the absence of financial markets, producers are condemned to take advantage of their opportunities only to the extent allowed by their own resources, while in other cases, when their resources are abundant compared to their productive options, they are forced to invest them at low marginal rates of return.

There is no reason to expect that those with the capacity to save, at a given moment, are necessarily those with the best investment opportunities. By making the division of labor between savers and investors possible, financial intermediaries channel resources from producers and regions with a limited growth potential and poor productive opportunities to those where a more rapid expansion of output is possible.

Through the provision of intermediation services, therefore, the financial system contributes to the elimination of inferior uses of resources and, at the same time, it facilitates better alternative uses of these resources. This is accomplished when the financial system offers wealthholders new assets (for example, bank deposits) that are more attractive forms of holding wealth than the unprofitable uses of resources thus eliminated. The intermediary, in turn, transfers these claims on resources to others, who possess better investment opportunities.

From this perspective, the financial system offers valuable services and income-increasing opportunities not only to borrowers, but also to depositors. Financial policies must create a balance, therefore, between the incentives offered to depositors (to attract their savings) and those offered to borrowers (to promote investment). Many credit programs and institutions in developing countries, however, have relied heavily upon international donor funds and central bank rediscounting, thus ignoring the provision of deposit services, while financial policies have repressed the rewards offered to depositors.

The financial system also facilitates the reduction of risk and the management of liquidity and reserves. Most economic agents accumulate stores of value for emergencies or to take advantage of future investment opportunities. In the absence of attractive domestic financial assets, they are forced to hold foreign currencies, real estate and other tangible assets (inventories, animals, jewelry) that yield low social returns. The financial system reduces the costs and risks of holding precautionary and speculative reserves when it offers attractive forms of holding wealth, while it reduces the size of the required reserves, thus releasing resources for immediately productive uses, if it offers open lines of credit when these are needed.

Finally, the financial system provides services of fiscal support for the public sector. This is an important contribution, in view of weak tax systems and the absence of securities markets. While the first three types of function (monetization, intermediation, and reserve management) are complementary, the fiscal function of the financial system may be in conflict with the first three. When abused, this fiscal role may lead to inflation, devaluation, and the crowding out of the private sector from domestic credit portfolios. In this instance, the financial system ceases to be an intermediary between private savers and investors, and it becomes a fiscal instrument to tax resources away from depositors, in order to finance the public-sector's current expenditures. Financial policy must strive, therefore, to strike a balance in the provision of these services.

In summary, economic development both depends upon and contributes to the growth and diversification of the financial system. Financial deepening matters to the extent to which it integrates markets, it provides incentives for savings and investment, it encourages savers to hold a larger proportion of their wealth in the form of domestic financial assets, rather than in unproductive inflation hedges, foreign assets, and other money substitutes, and it channels resources away from low-return towards better alternative uses.

The extent to which these services are provided depends on the size of the financial system in real terms (its purchasing power), and on the efficiency of its performance, as measured by the magnitude and dispersion of the transactions costs that are imposed on all, actual and potential, market participants.

Market fragmentation, the small size of the transactions, the high costs of information, risk and uncertainty increase the costs of financial transactions in developing countries. As a result, the net returns to depositors are low, the total costs of the funds to borrowers (including non-interest expenses) are high, the size of financial markets is small, the volume of funds channelled and the variety of the services provided are limited, and time horizons are short.

Financial progress requires a reduction of these risks and transactions costs. This cannot be done by decree (for example, usury laws). Rather, it requires greater competition and market integration, the exploitation of economies of scale and of scope, professional portfolio management and diversification, the accumulation of information, and the establishment of bank-customer relationships. Financial progress thus requires a hospitable regulatory and macroeconomic policy environment, viable institutions, and innovations in financial technology to reduce risks and transactions costs.

2. Financial Deepening in Costa Rica

During the 1960s and most of the 1970s, Costa Rica enjoyed a significant process of financial deepening and financial markets served as an important mechanism for economic growth. Following traditional measures of financial performance, such as the ratio of monetary aggregates to national income, the evolution of the Costa Rican financial markets would have been evaluated positively, compared to other developing countries.

During that period, the range of services offered widened, the network of bank branches was substantially expanded, the returns to domestic financial assets were positive, in real terms, and financial magnitudes, measured in constant prices, grew rapidly. Bank economic growth and price and exchange-rate stability explained this progress, even in the absence of explicit policy concern for financial development.

In addition to being a small and open economy, up to the mid-1970s Costa Rica was characterized by remarkable price stability. Between 1950 and 1969, the average annual rate of change of the Consumer Price Index was below two percent per year. The country did not experience double-digit inflation until 1973. Absence of inflation reflected the openness of the economy and an exchange rate that was fixed for long periods of time. The domestic price level, therefore, was determined by international price movements, during a period when international inflation was minimal.

The fixed exchange rate reflected, in turn, a revealed preference for monetary stability. In general, the country was willing to adopt enough of the monetary and fiscal discipline that was necessary to sustain the exchange rate and "maintenance of the external value of the colón" was a major objective of Central Bank policy.

As a consequence of exchange-rate stability and the absence of inflation, as well as of the relatively high rate of growth of real income, during the 1960s and most of the 1970s, Costa Rica experienced a significant degree of financial deepening. The ratio of the money supply (M2), in the broad sense of currency, and demand, savings, and time deposits, with respect to the GDP increased from 19 percent in 1960 to 43 percent in 1978. This ratio was comparatively high, particularly in contrast with other Latin American countries where high and erratic rates of inflation had resulted in severe financial repression. It reflected an increasingly successful effort to mobilize domestic resources through the banking system, despite the comparatively low ratios of domestic savings to national income.

Most of the "monetization" of the economy and the provision of a means of payments took place before the 1960s, since by then the ratio of the money supply in strict sense (M1) to the GDP had reached contemporary levels. Subsistence, non-monetary transactions became an insignificant proportion of the Costa Rican economy since the early 1950s and banking habits were rapidly adopted by the population. The largest portion of the impressive process of financial deepening observed during the 1960s and 1970s was associated, therefore, with increasing holding of non-monetary deposits (quasimoney).

The ratio of quasimoney to the GDP increased from 4.2 percent in 1961 to 19.2 percent in 1978. This reflected the diversification of financial portfolios, in order to more closely satisfy diverse tastes for returns, risk, and liquidity. Also, as inflationary pressures increased after the mid-1970s and the opportunity cost of transactions balances increased, these were increasingly kept in new forms, different from checking accounts.

The increasing mobilization of funds through the banking system made possible the rapid expansion of domestic credit. Between 1961 and 1971, the ratio of domestic credit to the GDP increased from 31 to 37 percent and it reached 42 percent in 1978. The higher credit to GDP ratios, when compared to the M2 to GDP ratios reflected the increasing role of foreign savings in financing the credit portfolios of the banking system.

Despite financial deepening, Costa Rica continued to rely heavily on foreign savings for the financing of domestic investment. In addition, numerous regulations and the administrative allocation of credit (<u>topes de cartera</u>) fragmented financial markets and increased transaction costs for all market participants.

Transactions costs were further increased by the bureaucratic style of the nationalized banking system, which had no incentive to modernize the supply of its services. The monopoly of the four state banks in the mobilization of monetary deposits (checking and savings accounts) led to a disregard for the interests of the depositors, while the excess demands for loans, as interest rates dropped below market levels, led to the increasing use of non-economic considerations in the rationing of credit.

Moreover, the loan portfolios of the nationalized banks showed an increasing concentration: among those privileged to have access to the loans, a few captured the largest proportion of the funds loaned. As a consequence of this, few benefited from the implicit interest-rate subsidy, particularly during inflationary periods, when the real rates of interest on loans became particularly negative.

During the 1960s, the interest rates charged on loans by the nationalized banks were positive in real terms and implied only a moderate subsidy, to the extent that they may have not reflected the full opportunity cost of claims on resources in the economy. During the 1970s, on the other hand, the implicit subsidy was substantial, even under conservative assumptions about the opportunity cost of credit. Interest rates were negative in real terms during the most of the mid-1970s and early 1980s.

As an extreme example, under the conservative assumption that the social opportunity cost of the loans was 10 percent per year, in real terms, the rate effectively charged on loans during

1974 was a negative -20 percent. Thus, the implicit rate of subsidy was 30 percent. Agricultural credit represented close to 60 percent of the value of the gross agricultural output and over one-half of the loan portfolio of the banks. This meant that, in the important case of agriculture, the grant transferred through subsidized credit was equivalent to 20 to 25 percent of the value of the gross agricultural output. On the other hand, only between 30 and 40 percent of the agricultural producers had access to bank loans, while the remaining 70 percent were excluded.

In addition, there was a high degree of portfolio concentration. In effect, in the case of the Banco Nacional de Costa Rica, which granted over one-half of all agricultural credit in the country, less than two percent of the borrowers (number of loans) accounted for over 60 percent of the amounts loaned for agriculture. About 10 percent of the number of loans corresponded to over 83 percent of the amount of credit granted.

This meant that about one percent of the agricultural producers of Costa Rica were receiving over 65 percent of the agricultural credit granted by the banks and over 65 percent of a substantial subsidy, equivalent to almost 25 percent of the value of the agricultural output, in 1974.

Due to the decline in inflation rates during the second-half of the 1970s, as well as the increase in nominal rates of interest, the magnitude of the subsidy declined, but it remained important. It significantly increased again during the early 1980s, while concentration of the loan portfolio was more accentuated.

In addition, by the end of the decade it was estimated that about 50 percent of the loan portfolio of the banks represented defaulted loans. There was a significant transfer on this count, too, to the few privileged very large borrowers who did not repay their loans.

3. Impact of the Crisis on the Financial System

During the 1980s, Costa Rica has been in the midst of an economic crisis, which resulted from a combination of long-term trends and unfavorable short-term, foreign and domestic, circumstances. The long-term, structural determinants of the crisis reflected a contradiction between the country's basic characteristics (small, open economy, relatively labor abundant, and with very specialized natural resources) and the features of the protectionist strategy of development adopted in the late 1950s. High costs and distortions resulted from the penalization of agriculture and the bias against exports.

The short-term determinants of the crisis have reflected major external shocks, such as sharp swings in the country's international terms of trade and drastic changes in the terms and conditions of access to international financial markets, as well as the unfortunate domestic policies adopted in response.

The financial system suffered significantly with the crisis, probably more than any other sector in the economy. There has been essentially a fiscal reason for this. When the stagnation and contraction of real incomes in the early 1980s reduced the rate of growth of government revenues, the authorities faced severe constraints for an additional mobilization of domestic resources with the use of the conventional tools of taxation. At the same time, public-sector expenditures and implicit, non-recorded subsidies and entitlements kept growing, at rates increasingly faster than those associated with revenues.

Given the increasing discrepancy between public-sector revenues and expenditures, for a while the authorities financed budget deficits by placing their debt abroad, in order to cushion the effect that otherwise the income decline would have had on aggregate spending. When the limit to the accumulated stock of public external debt which foreign lenders were willing to accept was finally reached, and programmed expenditures had not been reduced yet, the authorities forced the placement of their debt with the domestic financial system.

Domestic financing of public-sector deficits had two consequences. The expansion of domestic credit at a rate faster than the rate that would have maintained domestic price stability made it impossible to sustain the fixed exchange-rate regime and it resulted in the loss of international monetary reserves, accelerating inflation, and eventually to devaluation. On the other hand, the private sector was crowded out of domestic credit portfolios. Thus, growing fiscal deficits were financed with the loss of international monetary reserves, accelerating borrowing abroad, the inflation tax, and financial repression.

The Wholesale Price Index increased 65 percent in 1981 and

108 percent in 1982. December to December, this index augmented 117 percent in 1981 and 79 percent in 1982. The Consumer Price Index, in turn, increased 65 percent in 1981 and 90 percent in 1982. Exchange controls, multiple exchange rates, devaluation, and floating rates followed. The accompanying financial repression led to a significant contraction, in real terms, of the domestic financial system.

The rapid process of financial deepening experienced by Costa Rica in the earlier decades had accelerated in the 1970s. Between 1970 and 1975, domestic funds mobilization by the banking system had increased at an average rate of 6 percent per year, in real terms. Moreover, between 1975 and 1978, this rate reached an exceptional 20 percent per year, as a reflection of the coffee boom. Between 1978 and 1982, however, domestic funds mobilization declined at an annual rate of - 6.9 percent.

A high interest-elasticity and a high-income elasticity of quasimoney had also been reflected in the rapid growth of this component of the demand for money. Thus, the proportion of quasimoney in M2 increased from 34 percent in 1970, to 55 percent in 1978, and to 66 percent in 1981. Firms and households began to use quasimoney as transaction balances, as inflationary expectations grew. Moreover, transactions balances in foreign currencies became very important. By 1981, as a consequence of currency substitution, deposits in foreign currencies represented 28 percent of quasimoney. Deposits in dollars represented up to 11 percent of the Costa Rican GDP in 1983.

The contraction of the Costa Rican banking system during the crisis was dramatic. In constant 1978 prices, domestic funds mobilization dropped from 12,756 million colones in 1978, to 9,568 million in 1982. By 1982, M2 represented only 68.7 percent of its 1978 real value, since it dropped from 12,105 to 8,322 million colones. The sharpest reduction was experienced by M1, which diminished from 5,438 million colones in 1978, to 3.032 million in 1982. This was only 55.8 percent of the value reached in 1978 and was comparable to the level already reached by 1970. The reduction of quasimonetary deposits was less dramatic. By 1982 they represented 79.3 percent of their 1978 real value.

A similar contraction was experienced by the real value of domestic credit. Between 1970 and 1975, real domestic credit had increased at an average annual rate of 7.1 percent. This rate of increase more than doubled between 1975 and 1978. Although domestic resource mobilization declined from this year on, domestic credit increased through 1980, when it reached 14,097 million constant colones of 1978, aided by the inflow of foreign funds. During 1981 and 1982, however, domestic credit dropped dramatically. By 1982 it had declined to 5,875 million colones, at constant 1978 prices; only 41.7 percent of the 1980 level. After some recuperation in 1983, real domestic credit was still at its pre-1975 level.

The contraction was particularly acute in the case of domestic credit for the private sector, which declined from 8,544 million of constant colones in 1978, to 3,060 million by 1982, only 35.8 percent of the former value. In a few years, the Costa Rican banking system's supply of real loanable funds to the private sector had been reduced to one-third of its original value. Only in 1981, the real rate of change of domestic credit for the private sector became - 49.4 percent, followed by another drop of - 23.0 percent in 1982.

Costa Rican firms experienced a painful loss of access to bank credit for investment and working capital, in part because of the erosion of the purchasing power of the loan portfolios with rapid inflation, in part because of the crowding out of the private sector in those portfolios. This, in turn, took place at a time when inflation and devaluation had reduced the real value of their own funds and when, for all practical purposes, these firms had lost their access to foreign borrowing, in view of the moratorium on the Costa Rican public external debt and generalized turmoil in Central America.

Domestic credit for the public sector continued to increase through 1980, when it reached 6,247 million of constant colones. The following two years, however, it also dramatically declined. By 1982, it amounted to only 2,852 million, which represented 45.6 percent of the 1980 level. Thus, in the race between the expansion of credit for the public sector and inflation, eventually inflation was the easy winner. The strategy was self-defeating. Once the country's international monetary reserves were exhausted, accelerated credit expansion contributed to the decline of its real value.

The crowding out of the private sector in loan portfolios was pronounced. The share of the private sector in domestic credit had only declined from 87.1 percent in 1961 to 79.5 percent by 1975. However, by 1981 this share had dropped to 55.7 percent. Moreover, from the perspective of the annual net increments in domestic credit, before 1974 the private sector received at least three-quarters every year. This participation had declined to one-third by 1980. The evolution of the shares of the two sectors in the allocation of domestic credit reflects the fiscal root of the process of financial repression of the late 1970s and early 1980s.

The annual flow of credit for productive activities declined from 6,575 million colones in 1978, to 3,187 million, in 1978 prices, by 1982. This contraction was accompanied by significant changes in the allocation of the loan portfolios. The sharpest reduction was experienced in the flows of credit for services, transportation and storage, housing, and manufacturing, all of which declined to about one-third of their original value. Personal credit experienced a similar reduction. Credit for agriculture and livestock as well as for commerce diminished to about one-half of its original value.

The contraction, therefore, was not uniform; it was at the expense of the private sector, of the mobilization of deposits in domestic currency, of the regulated segment of the market, of the share of productive sectors in loan portfolios, and of the access of the smaller, poorer, riskier producers to financial services.

As a result of the contraction of the real size of the financial system, the ratio of M2 to the GDP declined from 41 percent in 1980 to 29 percent in 1981. If dollar-denominated deposits are excluded, the reduction was from 35 to 21 percent.

Moreover, significant portions of the portfolio of the banking system became overdue. To the extent to which these loans have not been written off, there has been an underestimation of the actual reduction in the banks' loanable funds. The decline of these financial ratios has also reflected, in part, the loss in relative market share of the regulated, institutionalized market. In recent years, there has been a vigorous development of non-regulated financial institutions. Not constrained by Central Bank and interest-rate regulations, these intermediaries have been more aggressive in the mobilization of domestic resources than the formal market. In this sense, the reduction in the levels of financial intermediation has been less than reported here.

Conclusion

In conclusion, financial deepening matters for economic growth and stability. Adequate macroeconomic management is critical, in order to create an environment hospitable to financial market development. Abuse of the fiscal function of the financial sector led, in the early 1980s, to a dramatic contraction of the Costa Rican regulated financial system. Both the degree of monetization and of intermediation declined. Economic recovery will require, in turn, renewed financial deepening. Macroeconomic stabilization, fiscal control, and financial liberalization will be essential ingredients in the process of recovery.

NOTES:

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